In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 872

MOHAWK LIQUEUR CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. App. 1a-7a) is reported at 209 F. Supp. 321. The opinion of the Court of Appeals (Pet. App. 8a-13a) is reported at 323 F. 2d 241.

JURISDICTION

The judgment of the Court of Appeals was entered on October 21, 1963 (Pet. App. 29a), and its order denying the taxpayer's petition for rehearing was entered on December 2, 1963 (Pet. App. 14a). The petition for a writ of certiorari was filed on February 28, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the taxpayer, a manufacturer of alcoholic beverages, is required to treat the amount of floor stocks taxes imposed on its stock of distilled spirits on hand as part of the cost of its inventory rather than as a current business expense.

STATUTE AND REGULATIONS INVOLVED

The relevant portions of the Internal Revenue Code of 1939 and applicable regulations are set forth in Appendix E to the petition (Pet. 19a–28a).

STATEMENT

The taxpayer is a manufacturer of various alcoholic beverages who is required to pay the federal tax on spirits distilled, removed from bond, or held for use or sale.[1] As of October 1, 1942, the taxpayer elected to inventory its distilled spirits and finished products on the LIFO (last-in-first-out) method. At that time the excise tax attaching at the time of manufacture of distilled spirits was $4 per proof gallon. In November, 1942, in 1944, and again in 1951 Congress increased this tax until in 1951 it amounted to $10.50 per proof gallon. Each time Congress increased the excise tax on newly distilled spirits (i.e., on spirits on which no previous excise tax had been paid) it also imposed a floor stocks tax in an amount equivalent to the increase in excise tax upon distilled spirits on

[1] Although floor stocks taxes come within the general category of excise taxes, both parties have, for the purpose of clarity, used the term "floor stocks taxes" when dealing with the taxes imposed on inventory on hand, and the term "excise taxes" when referring to other taxes, such as those imposed upon distilled spirits produced, obtained, or withdrawn from bond.

hand and upon which an excise tax previously had been paid at a lower rate. The purpose of the floor stocks tax was to equalize the tax on all distilled spirits, so that a tax at the increased rate would be included in the price of all spirits sold after the date of the tax increase. (Pet. App. 8a–9a.).

The taxpayer's beginning inventory on October 1, 1942, reflected, as part of its cost of goods on hand, both excise taxes and the compensating floor stocks taxes, such as those which had been imposed in 1940 and 1941. The taxpayer treated the excise taxes imposed in 1942 and subsequent years as a cost to be included in inventory produced or obtained after the effective date of such taxes. However, when the taxpayer paid the floor stocks taxes imposed in 1942, 1944, and 1951, it did not add these taxes to its closing inventories in those years but treated them as current business expenses fully deductible in the year paid. The Commissioner disallowed the deductions and added the floor stocks taxes to the taxpayer's closing inventory as part of the cost of its goods on hand for each of the applicable tax years. (Pet. App. 9a–10a.)

The District Court held (Pet. App. 1a–7a) that the floor stocks taxes should be considered as current expenses of the years in which paid. The Court of Appeals reversed (Pet. App. 8a–13a, 14a), holding that these taxes should be added to the cost of the taxpayer's inventory.

ARGUMENT

The decision below is plainly correct for two independent reasons. There is, moreover, no conflict among the courts of appeals, and the decision does

not present any issue of an importance warranting Supreme Court review.

1. As the court of appeals noted,[2] this case has nothing to do with the technicalities of LIFO, FIFO, or any other method of determining what part of the overall costs of an inventory should be attributed to the goods sold in a particular year. The use of inventories in accounting for the income of a business has two functions: first, it requires the capitalization of the costs of the business that are properly attributable to the goods on hand at the close of the taxable year; second, it provides a method of identifying *which* goods—among those on hand at the beginning of the year or acquired during the year—are deemed to have been sold during the year (the costs attributable to which are deductible as part of the cost of goods sold) and which are deemed to remain on hand at the end of the year (the costs attributable to which must be "capitalized" as the cost of closing inventory). It is only the second question—the identification of the goods sold and the goods retained—that it is the function of the LIFO or FIFO assumptions to answer. That question, however, is not in

[2] The court below stated (Pet. 12a):

"Conceding that under the LIFO method the costs of a beginning inventory are frozen, we do not see how this affects the manner in which costs subsequently incurred should be treated in the closing inventory. If such costs are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether LIFO, FIFO, or any other method is used. * * *"

issue in this case, for it is undisputed that much of the whiskey on which the floor stock tax was assessed must be deemed, under the LIFO assumption employed by the taxpayer, to have remained on hand at the close of the year. This case involves, therefore, solely the first question—namely, whether the floor stock taxes paid, admittedly attributable to the whiskey deemed to remain on hand at the end of year, must be capitalized as part of the "cost" of that whiskey or may be treated as a general administrative expense deductible in the year paid regardless of the volume of sales during that year.

It is plain that the floor stock tax involved in this case must be treated as a cost of the inventory and not as a current expense deductible in whole in the year paid. The floor stock tax, like the excise taxes which the taxpayer in fact capitalized as costs of inventory, is directly attributable to the particular goods on hand and was intended by Congress to be recovered by the taxpayer as part of the selling price of those goods. This tax, moreover, constitutes a very large percentage of the cost of the distilled spirits and of the selling price of the finished product (the alcoholic beverage). Finally, this tax, unlike the costs of storage or personal property taxes, is not incurred annually but only on a single occasion. For these reasons, a gross distortion of taxable income would result from treating the floor stock tax as a current expense rather than as an expense to be

recovered by the taxpayer on the sale of the stock of liquor which is taxed. In the year of sale, the taxpayer will presumably recover the amount of the tax in the form of an increased selling price. If, instead, the taxpayer is allowed to deduct the full amount of the tax in the year it is imposed, its income for that year will be distorted by creating a very large expense properly attributable to sales in later years, and its profits in later years will be exaggerated by failure to consider the effect of the tax on the cost of the goods sold in those later years.[3]

2. The Court of Appeals also correctly held that the taxpayer must be consistent in its accounting treatment of its inventory from year to year. (Pet. App 12a–13a.) Section 22(c) of the 1939 Code (Pet. App. 2a) confers broad discretion upon the Commissioner to determine the proper methods of taking inventory and the proper valuation of items of inventory. Section 29.22(c)–2 of Treasury Regulations 111 (1939 Code) provides that: "In order clearly to reflect

[3] There is no basis for the taxpayer's contention that the applicable provisions of the statutes and regulations do not permit adjustments to be made in the value of inventory when the LIFO method is used. The rules governing the use of the LIFO method (set forth in Section 22(d) of the 1939 Code) do not state how an item's cost is to be calculated. The general rules relating to the determination of the cost of inventory (set forth in Section 22(c) of the 1939 Code, and Section 29.22(c)–3 of Treasury Regulations 111) apply to all methods of inventory accounting. There is nothing in these provisions which prescribes a different and more limited meaning for the term "cost" when applied to the LIFO method, or which prohibits the Commissioner from insisting that the closing inventory for a taxable year must reflect costs properly attributable to the goods on hand at that time.

income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations." The taxpayer must be consistent both in the manner in which similar items are valued in any one inventory and in the manner in which the same item of inventory is valued from year to year.[4] The taxpayer in the present case treated both the excise taxes and the floor stocks taxes as part of the cost of its opening inventory as of October 1, 1942, and continued to account for excise taxes imposed upon distilled spirits produced, obtained, or withdrawn from bond in subsequent years as a cost of inventory in those years. Accordingly, the Court of Appeals was correct in holding that the taxpayer should not be permitted to deviate from the methods selected by it in order to deduct as a current expense the full amount of floor stocks taxes imposed in subsequent years.

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[4] See *Bobrow Bros.* v. *Commissioner*, 135 F. 2d 209 (C.A. 3d). See also, 2 Mertens, Law of Federal Income Taxation (1961 Rev.), Sections 16.05, 16.06.

CONCLUSION

For the reasons stated, the taxpayer's petition should be denied.

Respectfully submitted.

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